IN THE

Supreme Court of the United States

November Term, 1978

No. 78-869

In the Matter of
STIRLING HOMEX CORPORATION,
Debtor.

GREGORY JEZARIAN, GERALDINE JEZARIAN, LONETOWN COMPANY, HARRY E. JONES, ALECK GOLDBERG, as Custodian for MARK GOLDBERG, and MRS. D. WINDSOR DIXON,
Petitioners,

vs.

FRANK G. RAICHLE, Reorganization Trustee, LINCOLN FIRST BANK OF ROCHESTER; CHEMICAL BANK; THE CHASE MANHATTAN BANK, N.A.; THE FIRST NATIONAL BANK OF CHICAGO; MARINE MIDLAND BANK; THE TRAVELERS INDEMNITY COMPANY; and THE SECURITIES AND EXCHANGE COMMISSION,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit.

BRIEF FOR RESPONDENT FRANK G. RAICHLE, REORGANIZATION TRUSTEE

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The Opinion

The opinion of the court below is reported at 579 F. 2d 206 (2d Cir. 1978).

Jurisdiction

Petitioners' claim for jurisdiction is based on 28 USC § 1254(1).

Question Presented

Did the District Court, sitting as a Court of Bankruptcy, under the facts of this case abuse its discretion in subordinating the claims of allegedly defrauded stockholders to the claims of orthodox and conventional general unsecured creditors?

The District Court's disposition of the matter of subordination in the case at bar reads as follows:

"On all the evidence it is hereby[1]

> "ORDERED that, in the *exercise of discretion* the claims of allegedly defrauded stockholders are classified as subordinate to the claims of conventional general creditors." (Appendix D annexed to Petition, 29a.) (Emphasis added)

Accordingly, the resolution of the question presented involves an examination of the facts of this many faceted and complicated bankruptcy proceeding.

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[1] The Court's decision was made after a hearing at which much evidence was received and all the parties had an opportunity to be heard.

The Court of Appeals in its opinion stated, ". . . we will consider the more *narrow* question whether it was *inequitable* for Judge Burke to subordinate the claims by stockholders to those made by general creditors. We conclude that it was not." (Appendix A annexed to Petition, 13a.) (Emphasis added)

Hardly a subject of further review by this busy Court, especially in view of the fact that the Bankruptcy Reform Act of 1978 § 510(b) now directs such a subordination of claims of allegedly defrauded stockholders.

Facts

On July 12, 1972 Stirling Homex Corporation which had been in the business of mass producing individual apartment units or "modules" using assembly line production techniques filed a voluntary petition in the Western District of New York under Chapter X of the Bankruptcy Act, 11 U.S.C. § 501, *et seq.* Nearly five years later, in July of 1977 after futile efforts by the reorganization trustee to reorganize the company in the sense of floating out of the trusteeship a viable operating company, it was determined by the District Court that Stirling Homex Corporation was hopelessly insolvent. The District Court made and entered an order finding that Stirling Homex Corporation's assets amounted to $16,986,376 and that its debts amounted to $45,961,000 (4a). Accordingly, the District Court found the corporation insolvent and declared that its stockholders had no equity in the corporation and could neither vote on the plan of reorganization nor share in the distribution of the proceeds resulting from the liquidation of its assets. The corporation was a publicly owned company and various of the stockholders claimed to have been defrauded in the purchase of their stock. Certain of the allegedly defrauded stockholders made claims grounded on fraud and

securities law violations. The District Court, on application of the trustee under § 197 of the Bankruptcy Act[2], 11 U.S.C. 597, subordinated the claims of the allegedly defrauded stockholders to the claims of the orthodox and conventional creditors, including banks, suppliers and employees.

Argument

In the first place, so far as the granting of a writ of certiorari is concerned, we observe that the issue sought to be raised by the petitioners is not a "live one."[3] The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, subordinates as did the District Court the claims of all defrauded security purchasers; see § 510(b) of the Act. This section of the Bankruptcy Reform Act which is merely a codification of existing law provides as follows:

> "Any claim for rescission of a purchase or sale of a security of the debtor or of an affiliate or for damages arising from the purchase or sale of such a security shall be subordinated for purposes of distribution to all claims and interests that are senior or equal to the claim or interest represented by such security." (Bankruptcy Reform Act of 1978, § 510(b).)

In directing the subordination of the claims of so-called defrauded stockholders, even in the absence of a statute, the District Court was following the general rule of equity as well as equitable considerations peculiar to this case.

[2] Section 197 of the Bankruptcy Act reads as follows:

> "For the purposes of the plan and its acceptance, the judge shall fix the division of creditors and stockholders into classes according to the nature of their respective claims and stock."

[3] Indeed it never was.

> "As a general rule equity prefers the claims of innocent general creditors over the claims of shareholders or subordinated creditors deceived by officers of the corporation." *F.D.I.C. vs. American Bank Trust Shares, Inc.*, 412 F. Supp. 302, 308 (D.S.C. 1976).

Language directly in point with the case at bar is that of the court in *Carter v. Bogden*, 13 F. 2d 90 (8th Cir. 1926). The reporter's Note 1 in that case reads as follows:

> "Claims of innocent creditors of bankrupt corporation entitled to preference over those of stockholders deceived by its officers."

In the course of its opinion in that case the Court said at 13 F.2d 93-94,

> "Anyone, becoming a creditor of a corporation, has a *right* to rely on the security afforded by the money or assets paid in by the stockholders for its capital stock, and in a proper case equity will prefer the claims of innocent general creditors over claims of stockholders deceived by officers of a corporation (Citing cases.)" (Emphasis added)

This is our point exactly!

In the case of *Scott v. Abbott*, 160 Fed. 573 (8th Cir. 1908), *cert. denied*, 212 U.S. 571 (1908) the Eighth Circuit developed the history of the general rule that calls for the subordination of the so-called defrauded stockholders' claims to the claims of general unsecured creditors. In the course of its opinion the Court stated at 852,

> "In view of the foregoing facts and principles the rights of the innocent creditors are superior to those of the deceived stockholders."

The facts were similar to our case. In another case the Court said:

"Courts have repeatedly frowned upon the attempt of a stockholder after bankruptcy to 'lay aside the garb of a stockholder, on one pretense or another, and to assume the role of a creditor.' " *In re Groenleer-Vance Furniture Co.*, 23 F. Supp. 713, 715 (W.D. Mich., 1938).

In any event, the bankruptcy court has broad equitable powers with respect to the subordination of claims. See, *Pepper v. Litton*, 308 U.S. 295, 307 (1939), where the court said,

"As we have said, the bankruptcy court in passing on allowance of claims sits as a court of equity. Hence these rules governing the fiduciary responsibilities of directors and stockholders come into play on allowance of their claim in bankruptcy. In the exercise of equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate."

We now pass to a brief discussion of the facts which make the general rule particularly applicable to the case at bar.

The subordination of the so-called defrauded stockholders' claims to the claims of the orthodox and conventional unsecured creditors is justified, indeed called for in this case, by the consideration of the investment expectations of the parties. The equity investors, in this case, were seeking equity profits—high profits, many times the issue price—and assumed equity risks. The orthodox and conventional creditors, such as lenders, suppliers and workers, sought only a normal business profit. They bargained for debt type profits and certainty of payment. Stockholders are often prepared to wait long periods of time for substantial profits, whereas lenders and trade creditors, to say nothing of workers, expect a reasonably prompt payment.[4] Here they have waited six and

[4] The claims of orthodox and conventional unsecured creditors include the claims of hundreds of workers and small suppliers.

one-half years, and if petitioners could prevail, would face the prospect of years of further waiting.

Importantly, too, a subordination prevents straddling tactics such as those employed by these allegedly defrauded stockholders. A security holder seeking to rescind is attempting to avail himself of an alternative that the general creditor does not have. To use a current expression, he has the best of two worlds. If things go well he can elect to be a stockholder. If things go poorly, he seeks to be a creditor. The so-called defrauded stockholders in the case at bar[5] waited over five years after the filing of the bankruptcy petition on July 12, 1972 to threaten to make claims against the bankrupt estate. They waited until it was apparent that there was to be a liquidation and not a reorganization in the sense of floating out of the trusteeship a viable operating company. For the most part they had previously ratified their status as stockholders by attending meetings or voting proxies and, in the case of preferred stockholders, by accepting dividends as late as April 1972. The great majority of all the so called defrauded stockholders have heretofore filed statements with the Trustee alleging their status to be that of stockholders. We submit that five years later is too late in the day for them to assume a different role.

Another equitable consideration inheres in the fact that the allegedly defrauded stockholders have other remedies not available to lenders, suppliers or workers, including actions against the members of former management, underwriters, broker dealers, accountants and others who they may claim committed the alleged frauds of which they complain.[6]

[5] except for a negligible few, six in number, totalling $21,869.

[6] more specifically, claims under the Securities Acts *not available to creditors*.

"If the subscriber became a shareholder in consequence of frauds practiced upon him by others, whether they be officers of the bank or officers of the government, he must look to them for such redress as the law authorizes, and is estopped, as against creditors, to deny that he is a shareholder, within the meaning of § 5151, if, at the time the rights of creditors accrued, he occupied and was accorded the rights appertaining to that position." *Scott v. Deweese*, 181 U.S. 203, 213 (1901)

The so-called defrauded stockholders in the case at bar are pursuing such remedies.

The District Court's opinion gives a further cogent reason for subordination in the following language:

"If the claims of alleged defrauded stockholders are not subordinated to the claims of conventional general unsecured creditors, a wholly new element will have been created in the financial structure of business. No longer will creditors, whether banks, suppliers, or subcontractors, be free as they now are to extend credit to the ordinary course of business on their presumed right to be accorded priority over the claims of investors and speculators in securities, without first obtaining a secured basis which will guarantee them a priority status in the event their customer defaults. Such a fundamental change in the financial structure of the business community is unwarranted in the absence of legislation designed to overturn the long established rule of absolute priority." (28a)

Legislation directly to the contrary is now to be found in § 510(b) of the Bankruptcy Reform Act of 1978, *supra*.

The reasoning of the District Court grows on one the more one reflects upon the inequitable effect of rescission claims of defrauded stockholders if allowed on a *pari passu* basis with orthodox and conventional creditors. The rescission doctrine would permit claims for inordinately large amounts because

rescission under the Federal Securities laws potentially permits a stockholder to claim much more than the debtor's original selling price of the stock. We do not have to go further than the situation in the case at bar to illustrate this point. The debtor made two public offerings of its stock. It received $6 million as a result of its first offering in 1970 and $19 million as a result of its second offering on July 31, 1971. The common stock, which was issued for $16.50 per share, traded at prices as high as $50 per share a few months later. As appears from footnote 1 to the opinion of the Court of Appeals, Appendix A annexed to petitioners' brief, 4a, of the $39 million in total proceeds of the two offerings, the debtor realized $25,100,000. The loss to shareholders, taking account of intermediate market fluctuations in excess of the offering prices, while difficult to estimate, could be as much as $100 million (according to the estimate of petitioners' counsel) (7a).

If the estimate of petitioners' counsel is correct, the claims of defrauded stockholders would approximate four times the amount of money which the debtor received for the sale of its stock. As stated by Messrs. Slain and Kripke in their much discussed article,[7]

"A creditor who has relied . . . upon the existence of a $10 equity cushion under his claim against the issuer may see the $10 equity cushion turn into a $40 competing claim."

In such an order of things we ask, rhetorically, who is going to extend credit as a lender or supplier?

And, further, and to the same effect as the District Court's opinion, as one commentator put it,

[7] 48 N.Y.U.L. Rev. 261 (1973)

"A general creditor is entitled to a higher priority position because of the nature of the investment. When a creditor makes a loan after the stockholders have contributed captial to the corporation, the creditor relies upon the equity cushion of the stockholders. *The reliance need not be manifest—the stockholders are presumed to have knowledge of priority rights.* The court so held in *In re Irving Whitehouse Co.*[8] The court recognized the right of creditors to rely upon the shareholders' capital contribution. Credit is given to corporations with little or no knowledge of names of stockholders, but with confidence that, whoever they are, their rights in and to corporate property are subordinate to the rights of creditors. Thus, the creditor who has made a loan after stockholders or subordinated debt holders have invested in the corporation has a superior equity to the junior claimants, and should not be subjected to equal treatment with the rescinding security holders. (The Defrauded Investor, American Bankruptcy Journal, Vol. 50, 1976, p. 205.)" Emphasis added.

See, also, Slain and Kripke, *supra.*

The case of *Oppenheimer v. Harriman National Bank and Trust Co.*, 301 US 206 (1937), cited at p. 6 of the petition, is not in point. In national bank cases the statute requires a "*ratable* distribution on *all claims*" and vests no equitable powers in the controller making the distribution of assets to do otherwise. Thus, the situation in *Oppenheimer* was unlike a distribution under a plan comprehended by Chapter X of the Bankruptcy Act which requires a "fair and equitable" distribution. *Oppenheimer* was a national bank liquidation under the National Bank Act § 194, which reads in pertinent part as follows:

[8] 293 Fed. 287 (9th Cir. 1923).

". . . the controller *shall* make a ratable dividend of the monies so paid over to him by such receiver on *all* such claims as may have been proved to his satisfaction . . ." (Emphasis added.)

Here, however, we are dealing with a situation where the bankruptcy court in the exercise of its general equitable powers and those specifically granted by § 197 of the Bankruptcy Act has fixed "the division of creditors and stockholders into classes according to the nature of their respective claims and stock." In other words, in the *Oppenheimer* case the command of the statute, irrespective of considerations of fairness and equity, was plain and unmistakable. The distribution was to be, in the words of the statute, "ratable." In the case at bar the District Court in the exercise of discretion on the totality of the facts presented, reached the conclusion that a ratable distribution would not be "fair and equitable."

As observed by the Court in *Atlantic Gypsum Co. v. Federal National Bank of Boston*, 76 F. 2d 59 (1st Cir. 1935),

"Liquidation of national banks is controlled by statute; . . ."

A different statute from the one governing the case at bar.

The case of *Matter of Mobile Steel Co.*, 563 F. 2d 692 (5th Cir. 1977), cited at p. 11 of the petition, is not in point. In the first place it is a Chapter XI case while the case at bar is a Chapter X case. In the second place, the facts are entirely different from the facts involved in the case at bar.

Conclusion

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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